

Audit Requirements (revised 9/3/02)

INTRODUCTION.....	2
OVERVIEW OF AUDITS.....	3
1. What is an Audit?.....	3
2. What are the Purposes of an Audit?.....	4
3. Who Performs an Audit?.....	4
4. Who Pays for an Audit?.....	4
THE AUDIT PROCESS.....	5
1. An Auditor's Responsibility.....	5
2. The Municipality's and Auditor's Relationship.....	6
3. The Auditor's Report of Comments and Recommendations.....	6
HIRING AN AUDITOR.....	7
1. Who Should Select the Auditor?.....	7
2. Auditor Selection Criteria.....	8
3. The Selection Process.....	8
Preparing a Request for Proposal.....	8
Pre-Proposal Meeting and Information.....	9
What to do when Proposals are Received.....	10
Making a Final Decision.....	10
EXAMPLE: Sample Audit Finding.....	4

Audit Requirements

INTRODUCTION

Alaska municipalities are required by law (AS 29.35.120) to provide an annual independent audit of the accounts and financial transactions of the municipality or, in the case of a second class city, an audit or statement of annual income and expenditures. Copies of these audits or financial reports must be available to the public upon request. It is appropriate to charge members of the public the cost of making the copies.

In addition to the general requirements of Title 29, a municipality or unincorporated community is required by state and/or federal law to have an annual independent single audit done when during its fiscal year the municipality or unincorporated community spends \$300,000 or more in state or federal grant or program funds. There may also be additional audit requirements imposed by state or federal law for certain program or grant funds. These requirements should be spelled out in the agreement awarding the money. (Check with the State Audit Coordinator at Alaska Office of Management & Budget for more information, P.O. Box 110020, Juneau, AK 99811-0020 Phone: (907) 465-4666 Fax (907) 465-3008.) The audit must comply with the standards set out in the Single Audit Act and meet the requirements of OMB circular A-133.

If a community gets an audit that complies with the state or federal audit requirements, it is not required to then have a second audit or certified financial statement prepared under state statute. The single audit standards satisfy the state audit requirements for municipalities under AS 29.35.120.

Federal pass-through funds passed to an entity by the state are NOT considered state financial assistance. Financial assistance in the following form is not included when calculating whether an entity meets the threshold monetary requirement under this section:

- State revenue sharing provided under AS 29.60.010;
- Safe communities money provided under AS 29.60.350;
- Amusement and gaming tax money provided under AS 43.35.050;
- Aviation fuel tax money provided under AS 43.40.010;
- Electric and telephone cooperative gross revenue tax refunds provided under AS 10.25.570;
- Alcoholic beverage license fee refunds provided under AS 04.11.610;
- Fisheries tax refunds provided under AS 43.75.130.

Due to these state and federal audit requirements, many second class cities that have traditionally prepared annual statements of income and expenditures may now be required to provide for audits Conducted by a CPA. This section presents an overview of audits and reviews what an audit is, what its purposes are, who performs audits, and who pays for them. Also, it discusses the Municipality's and auditor's typical responsibilities during the audit process. This section ends with an outline of procedures a Municipality may use to hire an auditor.

OVERVIEW OF AUDITS

1. What is an Audit?

An **audit** is a systematic inspection of an organization's financial transactions and is designed to determine if they were recorded accurately and in accordance with generally accepted accounting procedures. An audit reviews a municipality's financial control procedures to determine if the municipality receives, accounts for, and expends funds properly.

Three common, related types of audits are the **financial audit**, **financial and compliance audit**, and the **single audit**. A financial audit is the type that satisfies the requirement of Title 29 that boroughs and first class cities must provide. It is designed to determine whether the financial statements of the municipality fairly present its financial position, and whether the municipality maintains records of financial operations in accordance with generally accepted accounting principles. In addition, the financial and compliance audit determines whether the municipality's financial transactions comply with applicable laws, regulations, policies, and procedures.

A single audit is the form of audit that meets the state and federal government single audit requirements described in the introduction. A single audit is an organization-wide financial and compliance audit and it is to contain the three following sections or reports:

- 1) The auditor's report on the municipality's financial statements. This states the auditor's opinion on whether the financial statements fairly reflect the municipality's financial condition.
- 2) The auditor's statement concerning the municipality's internal controls.
- 3) The auditor's statement on the municipality's compliance with applicable laws, regulations, or financial assistance agreement provisions. The auditors are also required in this section to identify any findings of instances of the municipality's failure to comply and any questionable expenditures that might be associated with these instances.

Typical Types of Audits

Financial Audit

Designed to determine whether the financial statements of the municipality fairly present its financial position, and whether records of financial transactions are in accordance with generally accepted accounting principles.

Financial and Compliance Audit

In addition to the above, it determines whether the administration of funds complies with applicable laws, regulations, policies, and procedures.

Single Audit

An organization-wide financial and compliance audit that conforms to procedures that satisfy state and federal funding requirements.

2. What are the Purposes of an Audit?

An audit serves two principal purposes in addition to meeting the legal requirements of state and federal funding programs. An audit will identify problems based on a thorough review of a municipality's financial control procedures and make recommendations that the municipality can use to improve its operations. Following is a sample audit finding and recommendations to improve the municipality's purchasing procedures:

Sample Audit Finding:

We noticed that receiving reports and packing slips are not compared to the purchase order and vendor invoice prior to payment. Check signers have no written evidence of invoice approval because the approval is verbal and not documented on the invoice. We recommend that the Municipal clerk compare the goods ordered and goods received to the invoice. The project manager should document his/her approval of an invoice by initialing and dating it before payment is made. Vendor invoices should be cancelled when paid to avoid duplicate payments. Periodically, the manager should compare check copies to approved invoices to confirm that the approval process is functioning properly. The manager shall initial the invoice and check copy to document this review.

Secondly, an independent audit provides valuable information to community residents. It assures residents that public funds are being well managed by their municipal government or it alerts them to problems, such as poor bookkeeping or mismanagement of funds that need to be fixed. Also, audits serve the interests of local residents by ensuring that the organization continues to be eligible for state and federal grants that provide needed services and they are not withheld in future years due to poor bookkeeping or mismanagement.

3. Who Performs Audits?

An **independent audit** is an audit performed by persons who do not have a direct interest in the organization being audited. For purposes of audits required by the state or federal governments, the auditor is typically a Certified Public Accountant (CPA) who meets federal General Accounting Office and American Institute of Certified Public Accountant standards. A CPA must conduct state and federal audits in accordance with the U.S. Comptroller General's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions (also known as the "GAO yellow book").

4. Who Pays for an Audit?

A municipality pays for a financial audit conducted solely for the purpose of meeting the requirement of Title 29. However, a percentage of state and federal financial assistance that the municipality receives can be used on a proportional basis to pay the cost of a single audit conducted to meet state or federal funding requirements. For example, if a grant accounts for 20 percent of the municipality's overall budget, 20 percent of the cost of the audit may be charged to the grant. In addition, if non-state funds are included in the audit, some of the costs of the audit should be paid for with non-state funds.

The size of the municipality's total budget and the condition of its accounting records are key factors affecting what an audit will cost since auditors typically base their charges on how long it takes to conduct an audit. There are no set guidelines for what an audit will cost. Contact several CPA firms and get rough estimates that can be used to budget for an audit.

THE AUDIT PROCESS

1. An Auditor's Responsibility

Financial auditing is an evaluation performed in accordance with well-developed professional standards. The purpose of a financial audit is to express an opinion about the municipality's financial statements, how fairly they represent the municipality's financial condition, and changes in the municipality's financial position. To do an audit, trained auditors must have a good understanding of the municipality's operations.

An audit is not specifically designed to detect errors and irregularities and if they exist, they may not be detected. Most CPAs include a provision in their contract, or submit a separate letter, stating that they are not responsible for detection of fraud or similar irregularities. However, if auditors do detect evidence of fraud, they are bound by their professional ethics to report it to the appropriate municipal officials. Any identified practices that could be caused by dishonesty will be listed in an auditor's report of comments and recommendations.

It is an auditor's responsibility to provide facts. Very few audit reports are issued without listing some needed improvements. This may have political implications. For example, people may question the competence of local officials if an independent auditor finds that a municipality's books are not well organized. Negative findings are seldom this extreme and the findings and recommendations for improvements are not meant to embarrass municipal officials. Instead, they are meant to help the municipality protect its assets through improving its financial operations and internal controls.

If single audit findings show problems in the administration of state or federal funds, or instances of non-compliance, certain state or federal agencies are responsible for resolving audit findings in consultation with the appropriate municipal staff.

The auditor will also want to see how well the organization's books were closed for the period to be audited, including whether adequate supporting documentation has been provided, and how accounts were reconciled.

If the municipality has this information organized and readily available, it will help hold down the costs of the audit. Similarly, if the municipality's books are up-to-date and appropriate reconciliations have been made, this may also reduce the audit cost. For example, if a municipality uses an audit firm from a different community, the municipality may be required to pay the auditor's travel costs, and their living expenses while they work on the audit. If the above materials are not well organized, or up to date, the auditors may need to spend more time in the community, or may need to make more trips. All of this adds to the cost of the audit.

2. The Municipality's and Auditor's Relationship

Both the municipality and the auditor should maintain a professional relationship. This helps ensure a successful and timely completion of the audit. To do this requires that both the municipality and auditor understand what is expected of them.

The municipality should expect the auditor to provide audit services in a professional manner, as scheduled. The auditor's staff should be well trained in audit techniques and the requirements of municipal auditing. They should develop sufficient knowledge of the organization's systems, financial affairs, and personnel to be able to provide good advice.

Auditors expect cooperation in the conduct of an audit. Unless the terms of the agreement state otherwise, the auditor expects to audit, not to perform bookkeeping functions. When an auditor asks for help in performing clerical tasks, the municipality is expected to be helpful.

Municipal personnel should not feel intimidated by auditors. It should be kept in mind that "time is money," and every means of completing the audit quickly should be used. This may mean extra work for clerical personnel. At no time, however, should the municipality forget that they are paying the auditor. The municipality has the right to expect that the auditor will not make unreasonable demands, and will treat municipal employees with the professional respect they are due.

Communications between municipal personnel and the auditor should be open and constant. This generally comes about naturally as audit personnel develop working relationships with municipal staff. However, formal communication channels should be spelled out to iron out problems that may arise. Someone in authority in the municipal administration should be assigned this responsibility on a day-to-day basis.

A common problem is having the same firm audit the books for many years. This may lead to complacency and lack of careful analysis of the transactions. There is a danger in becoming so comfortable with an auditing firm and its staff that the entity being audited doesn't pay enough attention to the details or require the auditor to all of the requirements of the contract, such as deadlines for delivery of the audit, etc.

3. The Auditor's Report of Comments and Recommendations

When an audit is completed, the auditor will submit a "Report of Comments and Recommendations" prepared by the auditor. A financial audit report will contain the auditor's comment on whether the municipality's financial statements fairly present its financial position. It may contain observations about any weaknesses found in the municipality's financial controls (the method of safeguarding the Municipality's assets), including information about how the municipality assures the accuracy of financial information, and how well the municipality adheres to financial policies. The report may also contain the auditor's recommendations for correcting any control problems that have been found.

A single audit report will include the auditor's findings concerning the municipality's compliance with applicable statutes, regulations, and provisions of the award in addition to comments on the municipality's financial statements and internal controls.

The quality of the report will directly reflect the auditor's skill, experience, commitment, and understanding of the Municipality's operations. The auditor should be asked to review the comments and recommendations, in draft form, with appropriate department personnel to verify the facts.

The audit committee, which is set up to select an auditor, should review the report to be sure it covers the concerns the municipality identified when it contracted to have the audit done. Finally, the report, and the responses to it, should be incorporated into one document and issued to the governing body.

Things an Auditor will expect from the Municipality

Generally, the auditor will expect the municipality to make available the following records and information:

- Meeting minutes.
- Adopted ordinances and resolutions.
- Cancelled checks.
- Bank statements.
- Check register.
- General ledger.
- General journal.
- Invoices to be paid.
- Paid invoices.
- Accounts receivable.
- Accounts payable.
- Bank accounts and their numbers.
- Name and address of the municipal attorney.
- Financial reports to the governing body.
- Budget and budget ordinance.
- Any budget revisions.
- Grant agreements and related documentation.
- Financial policies and procedures.
- Any previous audit reports.

Sample audit preparation checklists are included in the appendix of this handbook.

HIRING AN AUDITOR

Who Should Select the Auditor?

No one person in the municipal administration should select an auditor, because a typical audit covers operations of every department in the municipality and their financial activities. Similarly, municipal financial officials should not be in charge of selecting an auditor. The audit focuses on the municipality's financial systems, and it is also an evaluation of the people responsible for the system's operation.

An audit committee should be formed to select the auditor. The committee should include elected officials who have overall responsibility to the public for the departments being audited and the chief administrative officer. Informed citizens may also be included.

The committee should learn as much as possible about audit requirements. For example, if a financial and compliance audit is required, they should contact people and agencies that know about audits and auditors to understand what will be expected of the municipality. Once the committee has determined the audit requirements, it should establish the procedures it will follow in selecting an auditor.

Auditor Selection Criteria

The procedures the committee will follow in soliciting and evaluating an audit firm require good planning. If the audit objectives and selection criteria are clearly stated and understood by the audit committee, the selection process should result in a good relationship between the municipality and the auditor. Criteria for selection should include, but not be limited to:

- The skill, experience, and time commitments of the people who will be performing the audit.
- The auditor's demonstrated understanding of the municipality's audit requirements.
- The prior experience and reputation of the auditor in auditing cities of similar size.
- The price to be charged.

The Selection Process

Preparing a Request for Proposal

With the above criteria in mind, the committee should draft a **Request for Proposal** (RFP). A guide for preparing an RFP for auditing services is included in the appendix of this publication. When finished, publish a notice of availability for the RFP in a newspaper and send the RFP to potential auditors. The RFP should contain the following information:

- Identification of the financial records to be audited.
- The year, or years, to be audited.
- Special areas of attention (for example, state revenue sharing, state grants, federal grants, and cash management system).
- Requirements for the auditor's comments and recommendations report (for example, its contents, with whom it should be discussed, and its due date).
- Start and finish dates for the audit.
- Requirements to meet with municipal officials and administrative personnel to discuss problems make presentations, etc.
- Date and time the proposals are due and the number of copies required.
- Local contact person.
- Evaluation criteria.

The RFP should direct potential auditors to provide specific information about:

- Hours to be worked on specific tasks.
- Fees, billings, and payment terms.
- Resumes of the key personnel that will work on the audit.
- The audit firm's previous experience in auditing municipalities.
- Descriptions of the audit and procedures that will be used.
- Names, addresses, and telephone numbers of references.

It is advisable to send the RFP to auditors who have experience in local government auditing. The state Society of Certified Public Accountants (CPAs) may be able to furnish a list of CPAs who have this experience. The recommendations of officials of neighboring municipalities of the same size may also be helpful.

Pre-Proposal Meeting and Information

Most auditors require certain information to prepare the proposal. The best way to give them this information is to hold a meeting for those who plan to propose before the proposals are due. Representatives from interested audit firms can be invited to your municipality. Interested firms should be notified of the date, time, and place of the meeting. The municipality should make it clear that expenses required to attend the meeting are solely the responsibility of the interested firm and will not be reimbursed.

A member of the audit committee should make an opening statement describing the services being requested and the selection process. All department heads should be present to explain the operations of their respective departments. Key information provided by the municipality should include, but not be limited to:

- Key financial statistics, including the number of people on the payroll, an estimate of the number of bills paid over the period to be audited, total expenditures, and sources of funding.
- Descriptions of data processing operations. (Is a computer used to process payroll, keep track of inventory, or perform general ledger functions?)
- Frequency of **reconciliations**.

Participants should be encouraged to ask questions. It is a good idea to hold the meeting during the workday so that auditor(s) can observe people working. A summary of the pre-proposal conference should be prepared, and a copy should be provided to all contractors who requested a copy of the RFP.

If a pre-proposal meeting cannot be arranged because of distance or other factors, the same information can be written up for the local contact person to provide information to potential auditors over the phone or by mail.

Interested auditing firms should be advised in the RFP and any other communication to include additional copies of their proposal when they send it so that each member of the audit committee may have a copy to review.

What to do when Proposals are Received

After the proposal due date, copies of the proposals received by the municipality should be given to each member of the audit committee. Each proposal should be read carefully by each member. Any questions should be written down and the local contact person should contact the auditors to get answers to these questions. Some important questions to be asked, if the information is not in the proposal, include:

- What will the auditor do if any agency does not accept the audit report?
- Under what circumstances would the auditor bill the municipality for additional money beyond bid price?
- How much will the auditor charge to perform audits in later years?
- Will the auditor explain the role of each person in his firm and the number of hours to be spent on the audit?
- What steps will the auditor take if there is a finding a municipal employee is not doing their job?

Members of the audit committee should question the auditors about anything in their proposal that they do not understand.

Making the Final Decision

After the written proposals have been received, a person should be assigned to make calls to check the references. At the same time, each member of the committee should read the proposals using the selection criteria. When this is done, the committee should meet to decide which auditors to invite to make formal presentations, or, if this is not possible, to arrange for a conference call with the auditors.

Interview Top Choices

Only those with a chance of being hired should be included in the group to be interviewed. If possible, the choices should be narrowed to not more than three firms. Too many firms make the selection more complicated.

After the interview, or conference call, the committee should make its decisions taking care to talk with anyone it feels may help with the decision. The committee should document the reasons for its selection and explain them to the governing body. Notes should be taken during the interview or conference call so that the members of the selection committee can remember points that should be shared. The firm selected should be immediately notified by mail. Unsuccessful firms should be notified as well. If possible, the notification should include the reasons why they were not selected.